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E.O. 12958: N/A
TAGS: EFIN WTRO ECON EINV CH
SUBJECT: New Foreign Banking Regulations: Foreign Bankers are Optimistic, Chinese Banks are Wary

REFERENCE: Guangzhou 30413

(U) This message is sensitive but unclassified. Please handle accordingly.

¶1. (SBU) SUMMARY: Following the November 15 release of banking regulations that permit wholly foreign-owned banks in China, Guangzhou-based representatives of foreign banks believe they can now operate on a level playing field with domestic banks. Citibank and Deutsche Bank branch managers said their banks plan to incorporate locally in order to participate in full RMB business and issue credit cards. Their optimism was tempered, however, by a belief that a slow-moving approval process will limit their ability to gain market share. Chinese commentators expect a fierce battle between foreign and domestic banks and were critical of foreign banks' continued tax benefits. END SUMMARY.

New Banking Regulations: A Level Playing Field on Paper

¶2. (SBU) Guangzhou branch managers for Bank of America, Citibank, and Deutsche Bank told Econoff that the foreign banking regulations issued on November 15, 2006, are generally the same as the draft regulations released earlier this year. The regulations, which take effect December 11, 2006, allow foreign banks for the first time to create wholly foreign-owned enterprises (WFOEs) within China. WFOEs will be permitted to engage in a full range of RMB business with local customers. Foreign banks that do not incorporate locally will continue to be restricted geographically and limited to servicing bank accounts with deposits of RMB 1 million (USD 127,000) or more.

¶3. (SBU) The new regulations also allow WFOE banks to issue their own credit cards, a service previously off-limits to foreign banks. The Bank of America, Deutsche Bank, and Citibank representatives all said this is a major opportunity for foreign banks to generate new profits and cited it as a primary incentive to incorporate locally. Bank of America's Yu said she expects to see new regulations governing the credit card market in the near future. She also expects that China will soon establish a national system of deposit insurance, under which WFOEs (but not foreign branches) will be covered.

Areas of Concern: Credit Ratings, Liquidity Ratios, Capital Requirements

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¶4. (SBU) Foreign banking representatives noted that a negative consequence of incorporating locally is the likelihood of a lower credit rating. Deutsche Bank's Myron Shi said banks that handle derivatives will find this a serious concern. However, none of the representatives considered this issue a major impediment, and Citibank's Milson Lau expects that the parent company's credit rating will be given primary consideration.

¶5. (SBU) Bank of America's Julia Yu said the new regulations do not permit foreign banks to buy or sell government securities, which domestic banks can do. She also noted that the liquidity ratio of 25 percent that China is likely to impose leads to burdensome borrowing costs. Deutsche Bank's Shi noted that foreign banks that choose not to incorporate will see an increase in their capital requirements from RMB 100 million (USD 12.7 million) to RMB 200 million (USD 25.4 million).

Implementation Will Be a Barrier

¶6. (SBU) Though the representatives said the new regulations level the playing field on paper, they all expect that long procedural delays by Chinese authorities will slow their ability to expand as quickly as they would like. (NOTE: this is similar to what happened with the opening of China's insurance market. End note.) In addition, they are waiting for officials to clarify whether WFOEs would need two years of profit prior to opening new branches. Citibank's Lau said foreign banks are severely handicapped for local representation, particularly for residential banking in China, because of the extensive retail networks that domestic banks have already established. (Septel addresses the Citibank-led deal with Guangdong Development Bank.)

Details Still to Come

¶7. (SBU) Banking representatives expect China's Banking and Regulatory Commission (CBRC) to issue detailed rules by December 11, when the five-year post-WTO accession transition period ends. Areas that need to be addressed include the formulas for calculating asset/liability and liquidity ratios and the RMB/foreign currency ratio for branch capital requirements. Deutsche Bank's Shi said he was pleased to see that the regulations do not include a 1 percent general provision requirement on loans, and is waiting to see whether it will be added in the CBRC rules. The representatives are also hoping that CBRC does not impose limitations on the number of branches or sub-branches a WFOE may open.

Who Plans to Incorporate?

¶8. (SBU) Though many banks will decide to incorporate locally, those that concentrate on corporate banking may decide not to change, according to the representatives. The media has reported that Citibank, Standard Chartered, HSBC, Hang Seng, and Bank of East Asia intend to incorporate. Deutsche Bank's Shi did not say whether his bank has made a decision, but said he believes that incorporating is the best strategy moving forward. Julia Yu from Bank of America said incorporating makes good long-term sense from a business perspective, but acknowledged that Bank of America is limited in its options. (Bank of America agreed not to engage in retail business for three years as part of its deal to purchase a nine-percent stake in China Construction Bank in 2005.)

The Chinese Perspective: Giving Away Too Much

¶9. (SBU) In an interview with the Southern Weekend weekly newspaper, a manager with China Merchants Bank complained that foreign banks enjoy preferential treatment. He said WFOE banks will continue to enjoy a 15 percent tax while domestic banks pay 33 percent. Foreign banks are given a two-year maturity period for interbank lending,

compared with only four months for Chinese banks. In addition, foreign banks' headquarters can offer a broader range of services than those of Chinese banks. The article echoes a complaint by some Chinese banks that China is opening its banking industry faster than other countries. It noted that China is a base of operations for 71 banks from 21 countries, but Canada has only a dozen foreign banks.

¶10. (SBU) In an article in the influential Southern Metropolis Daily, commentator Chen Jialin argues that, despite the new regulations, the high costs in setting up branch networks will lead many foreign banks to buy stakes in local banks instead. He writes that in the short term foreign banks will target high-end customers with wealth management and credit card services. He believes competition between foreign and local banks will become particularly fierce in late 2007 and early 2008 as foreign banks expand their networks.

A Chinese Banker: Foreign Banks are Competitive

¶11. (SBU) Yu Xiaoping, General Manager of the Shenzhen Branch of the China Development Bank (a policy bank under the State Council), said foreign banks could find considerable success in China in small loans and community banking, trade financing, and credit cards. Calling the new regulations a true leveling of the playing field, she criticized Chinese banks as being too focused on large projects and too hesitant to offer loans to small enterprises and individuals. According to her, most Chinese consumers, if given the option, would choose to put their money in a foreign bank.

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